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BEFORE THE
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 657 (SUB-NO. 1)

MAJOR ISSUES IN RAIL RATE CASES

COMMENTS OF
THE GOVERNMENT OF THE TERRITORY OF GUAM

Pursuant to the Notice of Proposed Rulemaking ("NPRM") served in this proceeding on February 27, 2006, The Government of The Territory of Guam ("GovGuam") is submitting its opening comments with respect to several of the issues that were raised by the Board in the NPRM.

I. PREPARATORY STATEMENT

The NPRM identifies a number of issues that typically arise in the application of the stand-alone cost ("SAC") test that is used in rail maximum rate cases. It may therefore be somewhat surprising for GovGuam to be filing comments in this proceeding, when it is not participating – and is unlikely to participate – in any proceeding involving the determination of maximum rates for railroads. GovGuam is involved, however, in a proceeding which does require the Board to determine the maximum reasonable rates for the movement of freight between the mainland United States and the Territory of Guam. *See* STB Docket No. WCC-101, *The Government of the Territory of Guam v. Sea-Land Service, Inc. and Matson Navigation Company, Inc.* ("WCC-101").

In a decision served on January 6, 1999, in WCC-101, the Board adopted a three-step process for resolving this matter and, as relevant here, elected to address in Phase II an appropriate methodology for assessing rate reasonableness for the traffic that is in issue. The carrier defendants in WCC-101 have argued that the most appropriate methodology for determining the reasonableness of their rates was the SAC test that is used in rail rate cases involving the transportation of coal and other bulk commodities. For its part, GovGuam has argued that the appropriate methodology for WCC-101 involves the standards of reasonableness promulgated by the Federal Maritime Commission for application to water carriers in the Guam trade; these standards were set forth in what had been 46 C.F.R. Part 552, formerly and commonly referred to as the FMC's General Order No. 11 ("GO-11"), prior to the enactment of the Interstate Commerce Commission Termination Act and the effectiveness of 49 U.S.C. §13701.[1] And, in the oral argument that was held before the Board on November 16, 2005 in WCC-101 concerning the appropriate rate reasonableness standard, GovGuam again explained why the GO-11 was the most appropriate procedure for determining the maximum rates on the traffic at issue in that proceeding.

Recognizing that the Board might nonetheless elect to utilize the SAC test or, potentially, other standards that derive from the Constrained Market Pricing methodologies developed in *Coal Rate Guidelines, Nationwide*, 1 I.C.C. 2d 520 (1985), GovGuam also demonstrated that the Board's current application of SAC would need to be revised in several respects if it were to be selected as the appropriate methodology in WCC-101. For example, GovGuam noted that the "percent reduction" methodology that is typically used in coal rate cases was fundamentally flawed with respect to the traffic in the Guam water carrier trade, so that the allocation of revenues in excess of the SAC of

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[1] See the Initial and Reply submissions of GovGuam in Phase II of WCC-101, filed April 23 and June 17, 2002, respectively.

any hypothetical water carrier in this trade would need to be modified.[2] As the Board itself has questioned the continued validity of the percent reduction approach in such cases, and in view of the possibility that the Board will elect to utilize the SAC methodology in WCC-101, it is both appropriate and important for GovGuam to present its views on two of the issues raised in the NPRM.[3]

II. COMMENTS

A. The Board Should Not Continue the Mandated Use of the Percent Reduction Methodology in All Cases

If SAC is required to be used in Phase III of WCC-101, the Board's current application of SAC should be revised to eliminate the use of an across-the-board percent reduction of the excess revenues generated by the stand-alone water carrier. As demonstrated by GovGuam's reply brief on metholodogy, the percent reduction methodology would yield economically inefficient results in WCC-101, where the contribution each movement in the studied traffic group could make would not be maximized. To the contrary, application of the percent reduction methodology would lead to an inappropriate cross subsidy of competitive traffic by the captive traffic that is at issue in that proceeding.[4] Moreover, any future rate challenges by captive shippers could be "gamed" by the carriers using the approach discussed by the NPRM.

Because of the great distance between Guam and the U.S. west coast and the requirements for weekly service, both a hypothetical stand-alone carrier and the existing

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[2] See Reply Verified Statement of Phillip H. Burris, filed June 17, 2002, at 15-25.

[3] As the issues raised in the NPRM concerning the application of RCAF productivity and the use of movement-specific adjustments to the Uniform Railroad Costing System are not relevant to the issues in WCC-101, GovGuam is not addressing those issues.

[4] GovGuam Reply Submission, filed June 17, 2002 at 13-14; Reply Verified Statement of Phillip H. Burris at 15-17.

incumbent carriers must handle more than the issue traffic in order to maximize the efficient use of the vessels' capacity. All the volumes moving in the TransPacific trade, other than shipments to/from Guam and other points in domestic offshore trade, can be handled by both U.S. flag and foreign flag carriers and are therefore moving in a highly competitive market. And, the domestic offshore trade – which is not a competitive trade but is instead served by only two carriers – is only a small portion of the overall TransPacific trade.

As a result, the economics of the Guam trade are very different from that of the North American rail markets where SAC and the percent reduction methodology has historically been applied. While North American rail markets consist of a multitude of shippers with substantially different demand elasticities and revenue to variable cost ratios, carriers serving Guam essentially carry freight moving in two separate markets. One market is comprised of shippers and receivers in Guam who tender or receive freight that moves to or from other points in the United States and are therefore subject to duopoly pricing due in large part to entry barriers created by the Jones Act and the requirement to use U.S. flag vessels. The other market consists of TransPacific cargo shippers that participate in a highly competitive market paying substantially lower rates than those of the Guam shippers; this vastly disparate pricing exists even though they constitute a homogeneous traffic group that receives essentially the same service with the same variable costs per FEU-mile. In the competitive TransPacific market, individual carriers have little ability to set and enforce prevailing prices, while Horizon Lines, LLC and Matson Navigation Company, Inc., the respondents in WCC-101, maintain almost complete control over prices in the Guam market. And, as the Guam trade is only a small portion of the overall shipper group that would likely be included in any profitable stand-alone carrier, any surplus aggregate revenue over aggregate cost will be relatively small. Regardless, any surplus that does exist will be entirely attributable to the high rates paid by the captive Guam traffic rather than the low rates paid by the competitive TransPacific trade.

The percent reduction methodology, by definition, would maintain the relationship between the existing individual rates of the captive shippers (*i.e.*, Guam), by also reducing the rates to the competitive TransPacific cargo which are already set at or near the carriers' marginal cost. On the other hand, in order to ensure that competitive traffic contributes maximum possible revenue, thereby avoiding an impermissible cross subsidy, and preserve Ramsey pricing principles on captive traffic, the difference between aggregate SAC revenues and aggregate SAC costs must be allocated to the traffic moved by the SAC carrier whose rates exceed the stand-alone cost per FEU-mile. In this situation, it would be illogical to use a methodology that necessarily reduces the rates on cargo whose current rates are already less than or equal to the SAC cost per FEU-mile.

In the NPRM, the Board proposes to replace the percent reduction methodology with either the Maximum Contribution Methodology ("MCM") or the Maximum Markup Methodology ("MMM"). Both approaches would calculate a maximum contribution from each movement in the traffic group such that the total contribution from the traffic group would equal the total SAC cost and with no shipment assigned a contribution higher that the current rate charged for the movement. As such, the MCM and MMM approaches would be a significant improvement in deriving reasonable rates for Guam shippers that can be achieved using the percent reduction methodology.

Under the MCM method, the Board would assume that the current rates charged for the competitive traffic reflect profit-maximizing rates. If a movement's share of the SAC cost is higher than what is actually charged, the MCM approach would reapportion the difference between the current rate and its share of SAC costs to the remaining traffic in the SAC traffic group, which would increase the contribution level from the remaining traffic.

In contrast, using the percent reduction methodology an across-the-board reduction would almost necessarily cause the highly competitive TransPacific cargo rates to fall below the carriers' cost of providing service, thus creating a cross-subsidy, which contravenes CMP's Management Efficiency Constraint.[5] Moreover, the MCM approach requires the carrier to recover as much of its costs as possible from each shipper before charging higher rates to its captive shippers, and thus maximizes the contribution from all shippers.

Alternatively, the Board proposes the MMM approach for those instances where the traffic group is diverse and comprised of various disparate volumes and handling characteristics. To make this analysis in rail cases, the parties would determine the variable cost of each shipment in the traffic group using the Uniform Rail Costing System ("URCS") and then express the maximum contribution towards SAC cost as a markup above variable cost. In no instance would the rate be set above the existing rate, even though the current rate may be less than the average markup above variable cost.

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[5] The Management Efficiency Constraint states that the carrier cannot force captive traffic to cross-subsidize competitive traffic moving at rates that are less than marginal costs. 1 I.C.C. 2d at 537-42.

It is premature to state that the MMM alternative is neither needed nor feasible in the factual situation present in WCC-101. In the first place, the traffic group is not diverse, in that the containers moving to Guam are handled in essentially the same manner as the containers moving in the TransPacific trade; hence one of the stated bases for using the MMM alternative is absent. Moreover, and unlike the situation in rail cases, there is no equivalent to the URCS for the water carrier industry. While it is possible that the FMC's GO-11 methodology could be modified to produce variable costs for individual shipments, there is no such unit cost statistical system currently in existence for water carriers. Hence, the use of MMM for the traffic at issue in WCC-101 would create the need to develop a unit cost system out of, presumably, the GO-11 system. But if that was done, one of the bases urged by the respondent carriers for using the SAC costs – namely, the lack of current and relevant GO-11 data – would no longer be true and there would be no need to use an SAC approach for determining maximum rates at all.

Finally, GovGuam believes that if CMP and the stand-alone cost constraint is used in this proceeding, the Complainant should be free to select the most appropriate and equitable rate reduction methodology once it has been determined that the aggregate stand-alone revenues exceed the aggregated stand-alone costs. In a given case, the Complainant may opt for MCM or MMM. Whichever process is selected, the methodology should have the goal of maximizing the contribution from each movement in the traffic group such that the total contribution from the traffic group would equal the total SAC cost, with no shipment assigned a contribution higher that the current rate charged for the movement.

B. Stand-Alone Cost Analysis Period

The Board and its predecessor agency, the Interstate Commerce Commission, have typically used a multi-year analysis rather than a single year analysis when determining stand-alone costs in order to deal with the effect of taxes and accommodate the impact of business cycles. Historically, the Board has used a 20-year analysis period for this purpose in most SAC cases.

The Board now believes, however, that the analysis period should perhaps be shorter than the 20 years and proposes to use a 10-year analysis period, for five reasons. First, the Board believes that as a practical matter the benefits of a 20-year analysis and potential rate prescriptions do not last longer than 10 years because of changes in circumstances surrounding the issue traffic and the stand-alone traffic group.

Second, the Board has determined that the average business cycle is much shorter than 20 years and can be captured within a 10-year analysis period. Third, a shorter period would reduce the expense and complexity of the SAC analysis by limiting disputes over forecasted trends in traffic volumes, revenues, and operating expenses. Fourth, a shorter period for the SAC analysis and resulting rate prescription period would conform its regulatory process to the trend in the rail industry towards shorter contract terms. Finally, the Board believes that its proposal would remove the need for shippers to hypothesize a stand-alone carrier with sufficient infrastructure to handle traffic forecasts that might be realized decades into the future.

While GovGuam appreciates the reasons underlying the Board's proposal to shorten the SAC analysis from 20 years to 10 years and agrees that it may be appropriate to do so in prospective rail rate cases, the situation in WCC-101 compels a different approach. WCC-101 was initiated before the Board in September 1998 and GovGuam is seeking statutorily allowed reparations that would date back to September 1996, which constitutes a ten year period just for the past. As the Board has not yet decided upon the appropriate methodology to use in WCC-101 to determine maximum reasonable rates, it will certainly be many months and possibly several years before discovery is initiated and completed and the record is closed in this proceeding. Thus a 10-year analysis period will not even cover the time frame during which WCC-101 will have been pending and, hence, is not adequate for the purpose of this rather unusual proceeding.

Moreover, the rationale supporting a shorter time frame is not relevant to the situation presented in WCC-101. For example, due to the long time frame for which historic traffic and revenue data would be used, the Board's concern over using long-term forecasts of traffic, revenues and operating expense would not be an issue even if a 20-year SAC analysis was ordered.

For these reasons, GovGuam believes that the duration of the SAC analysis should be determined on a case-by-case basis and in any event not necessarily limit the analysis in WCC-101 to a 10-year period. In other words, given the unusual procedural posture of the proceeding in WCC-101, a 20-year analysis would not result in the problems cited by the Board or otherwise do more than ensure that the parties to this case can develop an adequate record which does not become prematurely stale.

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CERTIFICATE OF SERVICE

I hereby certify that I have this 1st day of May, 2006, served a copy of the foregoing Comments of The Government of the Territory of Guam on the following persons listed below via first-class mail, postage pre-paid:

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